

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2006 through the Fourth Quarter of 2009

The nation's economy is expected to slow from a gallop to a trot over the next few quarters. Two factors play major roles in this transition: the housing sector and energy prices. The cooling housing sector will take a toll on U.S. output. However, the negative impacts from housing will be dampened by falling energy prices. The bottom line is the U.S. economy is entering an extended period of below-trend growth (seven successive quarters of less than 3% growth). Although growth will slow, a recession is unlikely. After successfully negotiating a soft landing, the U.S. economy will once again grow above 3.0% annually in 2008.

The U.S. housing downturn chops 1.3 percentage points off of GDP in this year's third and fourth quarters, through its direct effect on construction. In many parts of the country rising home prices and interest rates have made home purchases unaffordable to average income households. As a result, inventories of unsold homes have swelled. This rising tide of unsold homes has brought a sharp response from builders, whose confidence has dropped to its lowest level in 15 years. This suggests building activity will fall as builders try to get control of inventories. Housing starts are expected to drop 12% this year and 13% in 2007. The forecast also assumes the softer housing market will cause national home prices to decline 1.5% in 2007. But the negative impacts of the cooling housing markets will affect more than housing starts and home prices. Consumer spending will also suffer because lower levels of home sales mean spending on items like carpets and furnishings will diminish.

Retreating energy prices will soften the blow of the retreating housing market. Fears of major supply disruptions have all but disappeared, which have sharply reduced the risk premium in the oil market. Oil prices shot toward \$80 per barrel this summer on geopolitical fears and the looming hurricane season. With the war over and situation in Iran calm, and no repeat (so far) of last year's catastrophic storms, oil prices have eased this fall. The spot price of West Texas Intermediate (WTI) crude plunged 12.6% in September to average \$63.87 per barrel, which was down \$9.18 from August. The WTI dipped below \$60 per barrel in early October. Falling crude oil prices and plentiful supply have trimmed gasoline pump prices to their lowest level in over six months. Natural gas prices have also eased, thanks to plentiful supplies. These declines are akin to tax cuts for consumers. For example, it has been estimated the recent drop in gasoline prices have saved Americans \$84 billion, or 0.9% of disposable income.

With oil prices falling and inflation beginning to ease, the pressure on almost all central banks will diminish. In this forecast, it is assumed the Federal Reserve has finished raising interest rates. The nation's central bank will hold its federal funds rate at 5.25% for an extended period of time and then make three rate cuts next year. In addition, other central banks should also adopt less restrictive monetary policies. These policies are in sync with many industrial countries' fiscal policies. The good news is both the U.S. and global economies seem better equipped to withstand shocks compared to a few decades ago. This increased resilience has also been accompanied by shallower downturns and longer expansions. Thus, this improves the odds of a soft landing.

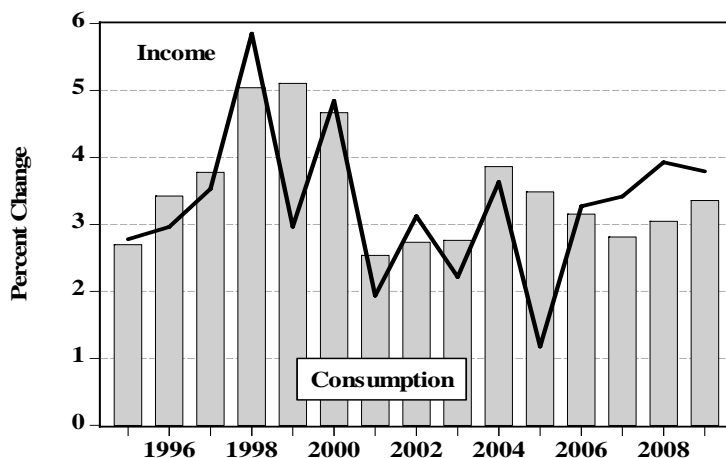
SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: American consumers are expected to rediscover thrift and live within their means over the forecast period. This change marks a reversal from recent years when climbing home values raised U.S. households' net worth which caused consumers to spend with relative abandon. As a result, real consumer spending grew faster than real disposable income in 2003, 2004, and 2005. This spending spree was financed by debt and reduced savings, both of which are the result of rising housing values. While the average sales price for existing homes grew 6.6% per year from 1995 to 2005, it accelerated to 8.5% per year from 2002 to 2005. This rising home equity not only gave homeowners the confidence to spend money faster than

their income grew, but it also provided the funds. Many Americans tapped into the increased equity in their homes to expand spending faster than their income growth. This financing option was made even more attractive by relatively low interest rates and aggressive bank lending practices. As a result, household monthly financial obligations grew to 18.5% of disposable income—its highest level in the history of this series that began in 1980. Not only were consumers taking on more debt, they were saving less. Like the soaring stock market earlier this decade, rising house prices seemed to assume putting money in the bank was unnecessary. As a result, the U.S. personal savings rate dipped below zero in the second quarter of 2005 and has remained negative. The twin strategies of taking on more debt and ignoring savings to fuel spending is not likely to work in the future. Existing home prices are predicted to decline this year and grow slowly thereafter, removing an important source of funds. In addition, the cooling housing market should douse any kindling embers of continued runaway spending. Debt-leveraged spending will be further dampened by more restrictive lending practices. The lack of savings will also limit future spending. Not all the spending news is bad. Falling energy prices will help limit the spending decline. These factors suggest real consumer spending will slow to a pace more in line with income growth. Specifically, real disposable income is forecast to increase 3.3% in 2006, 3.4% in 2007, 3.9% in 2008, and 3.8% in 2009. In comparison, real consumer spending is forecast to rise 3.2% in 2006, 2.8% in 2007, 3.0% in 2008, and 3.4% in 2009.

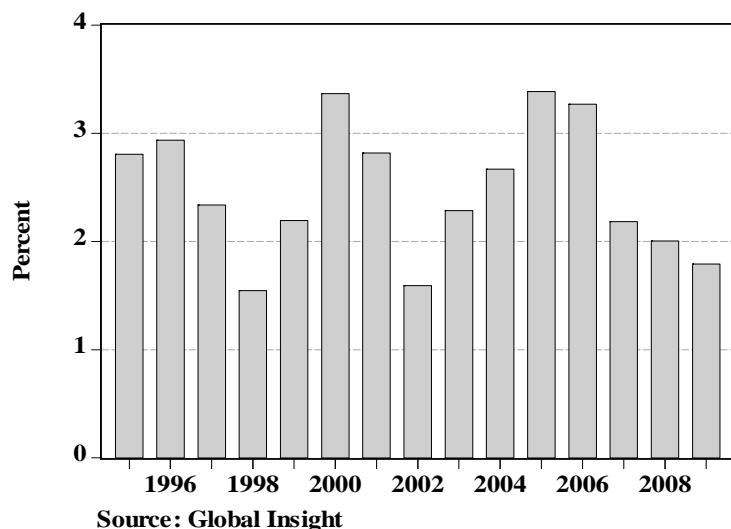
Inflation: Falling energy prices have helped quell inflation fears. Oil prices shot toward \$80 per barrel this summer on fears caused by the war between Israel and Hezbollah, the nuclear ambitions of Iran, the looming U.S. hurricane season, and supply problems in Venezuela and Nigeria. With the war over and situation in Iran calm, and no repeat (so far) of last year's catastrophic storms, oil prices have eased this fall. The spot price of West Texas Intermediate (WTI) crude plunged 12.6% in September to average \$63.87 per barrel, which was down \$9.18 from August. The WTI dipped below \$60 per barrel in early October. Falling crude oil prices and plentiful supply have trimmed gasoline pump prices to their lowest level in over six months. Natural gas prices have also eased. The September Henry Hub spot price averaged \$4.90 per million Btu, falling below \$5.00 per Btu for the first time since November 2003. The lower price reflects abundant natural gas supplies going into the heating season. In fact, natural gas in storage set a record in early October and was headed to the maximum storage capacity. While inflation risks associated with energy prices have ebbed, another wildcard remains: labor costs. Given the current

U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

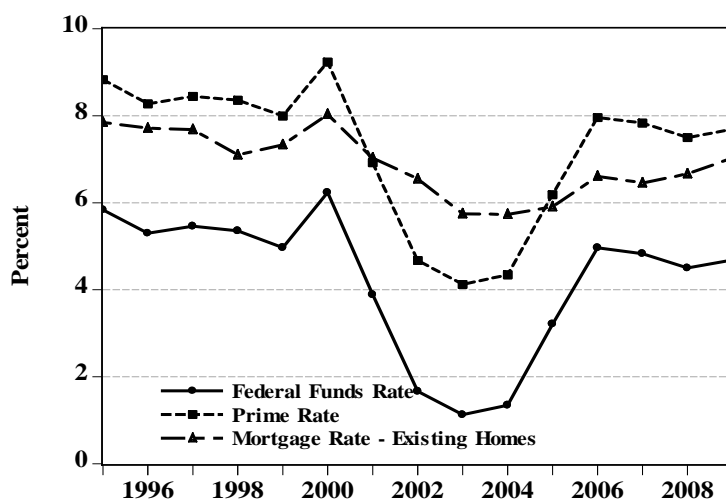
Consumer Price Inflation



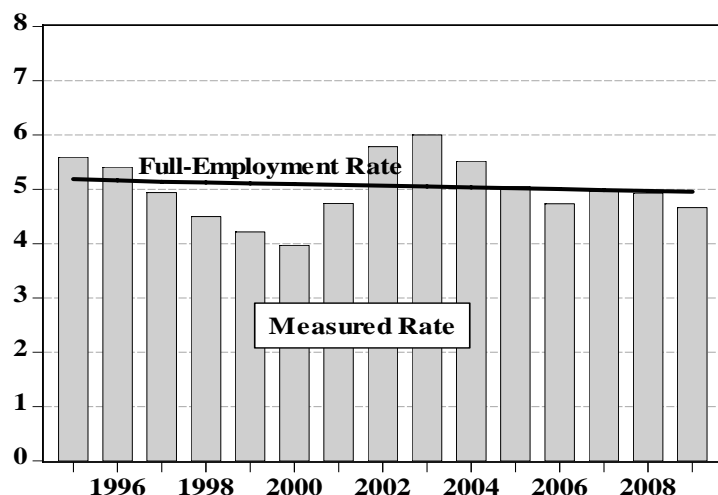
tight labor market, economists have been on the lookout for rising labor costs. The recent upward revisions to hourly nonfarm business compensation have caught their attention. This measure soared by 9.0% in this year's first quarter and 4.9% in the following quarter. However, this surge does not portend elevated compensation because it probably reflects stock option payouts that are not part of firms' fundamental cost structures. However, if these labor cost increases persist, they are warnings that inflation could rise faster than has been forecast. The consumer price index should rise slowly over the next few years. After increasing 3.3% this year, it will rise 2.2% next year, 2.0% in 2008, and 1.8% in 2009.

Financial Markets: Financial markets are responding to the sharp energy price declines. For example, the pricing of long-term inflation expectations and uncertainties has dropped sharply. The significantly reduced expectations for growth, inflation, and short-term interest rates have pushed Treasury bond yields down over the past four months. The 10-year Treasury yield declined from about 5.1% in early June 2006 to 4.7% in the first week of October. Mortgage interest rates and corporate bond yields have also declined. The combination of lower growth and inflation helped the Federal Reserve avoid an unpleasant bout of déjà vu. The nation's central bank watched inflation heat up this summer as the economy was cooling down. Former Federal Reserve Chairman Paul Volcker confronted similar conditions nearly three decades ago. During his watch, the Federal Reserve tightened its policy in order to break stagflation's back. His plan was successful, but caused a recession. Current Federal Reserve Chairman Ben Bernanke is no doubt hoping for a softer landing. To this end, the Federal Reserve has wagered on a wait-and-see policy. So far this bet is paying off. The recent drop in oil prices have taken away some of the fuel from the inflation fire. As a result, the Federal Reserve chose not to raise its federal funds rate during its October 24, 2006 meeting. This forecast assumes the Federal Reserve will continue its current policy through the rest of 2006. During 2007 the central bank is expected to reduce the federal funds rate by 25 basis points on March 21, June 28, and August 7. As a result, the federal funds rate should drop to 4.5% by mid-August 2007. This bellwether interest rate should remain at 4.5% through 2008 then gradually rise in 2009.

Selected U.S. Interest Rates



U.S. Civilian Unemployment Rate



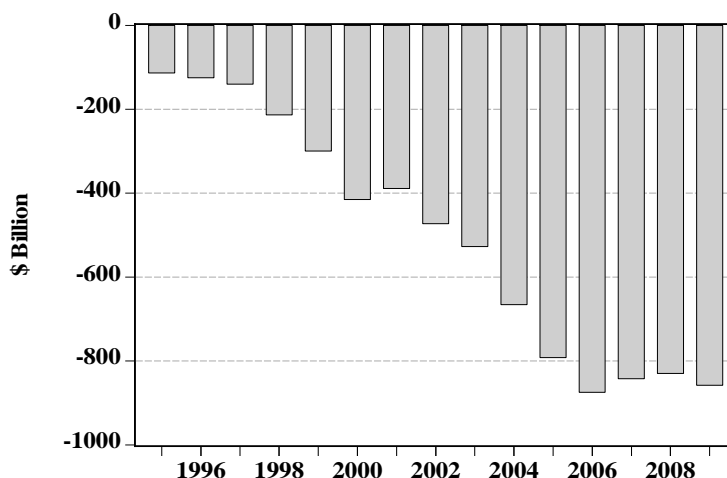
Source: Global Insight

Employment: National nonfarm employment increased by a disappointing 51,000 jobs in September, which was its weakest non-hurricane month showing since July 2004. Many industries experienced sub-par performances. Retailing lost jobs, as did manufacturing. However, not all of the labor market news was bad. In September, the U.S. unemployment rate dipped to 4.6% on solid household employment gains of 271,000. The labor market appears to be sending mixed signals. Namely, how can the unemployment rate be so low despite the recent meager job growth? The most persuasive explanation is the official job counts are underestimating actual activity. A

couple of facts support this argument. First, the federal government has revised its July 2006 and August 2006 estimates upwards by 62,000 jobs. Second, and more important, the U.S. Department of Labor recently reported it undercounted nonfarm job gains from March 2005 to March 2006 by (0.6%), or about 810,000 jobs. This revision was three times larger than the 0.2% average revision during the past ten years. One possible source of the undercount is new company formations that are notoriously hard to estimate. It needs to be pointed out that if payroll employment after March 2006 is raised, recent performances would look less mediocre, but still soft compared to previous gains. Nonfarm employment is expected to slow through 2007 then accelerate during 2008 and 2009. Specifically, U.S. nonfarm payroll should advance 1.4% in 2006, 1.1% in 2007, 1.4% in 2008, and 1.6% in 2009. During this period the U.S. civilian unemployment rate should fall in the 4.7% to 5.0% range, which is close to the full-employment level.

International: The U.S. economy is shifting into lower gear, and will take most of the global economy with it. The global economic cooling should not come as a surprise since the U.S. economy has been the engine of world economic growth over the last few years. The 2006 economic growth rates of important U.S. trade partners—Canada, Japan, Mexico, and Europe—should drop below their respective 2005 paces. Europe is expected to experience the most noticeable slowdown. Thanks to the anticipated tightening by European Central Bank, Eurozone economic growth will slip from this year's 2.5% pace to 1.7% next year. Not even China will be immune from the global economic cooling. Its real output is predicted to “slow” from 10.6% in 2006 to 9.0% in 2007. The nation's trade deficit will improve slowly over the next few years. The U.S. current account deficit set a new record in August 2006 of \$69.6 billion, which was up from the old record of \$68.0 billion set in July. Both exports and

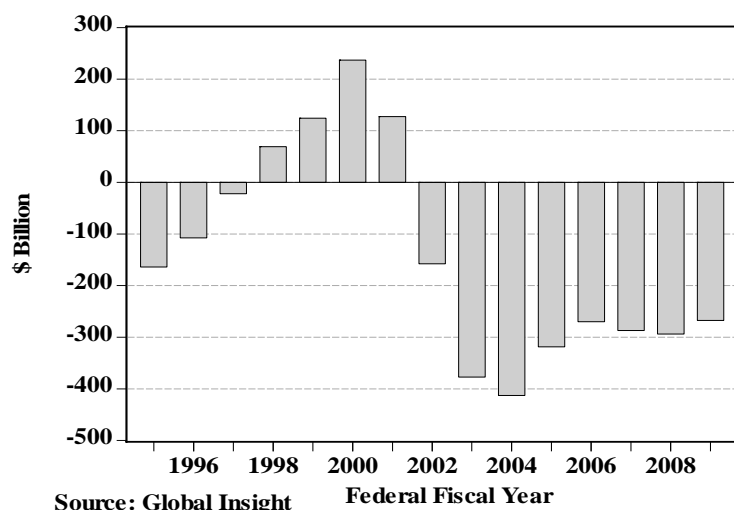
U.S. Trade Deficit



Source: Global Insight

imports rose in August, with import growth the stronger of the two. Oil accounted for almost half the increased deficit, with oil imports rising thanks to higher prices and volumes. Oil prices will swing the monthly trade picture over the next few months. The rise of oil prices pushed the trade deficit higher in August, but the price plunge in September should help narrow the trade gap in the future. The bad news is, even with the recent drop in oil prices, this year's trade deficit will be larger than in 2005. The good news is the trade deficit should begin to improve after this year, thanks to falling oil prices and revived U.S. exports. Specifically, the nominal current account balance will drop from \$874.6 billion this year to \$857.9 billion in 2009. Adjusted for inflation, the deficit shrinks from \$625.8 billion in 2006 to \$555.5 billion in 2009.

U.S. Federal Government Surplus Unified Basis

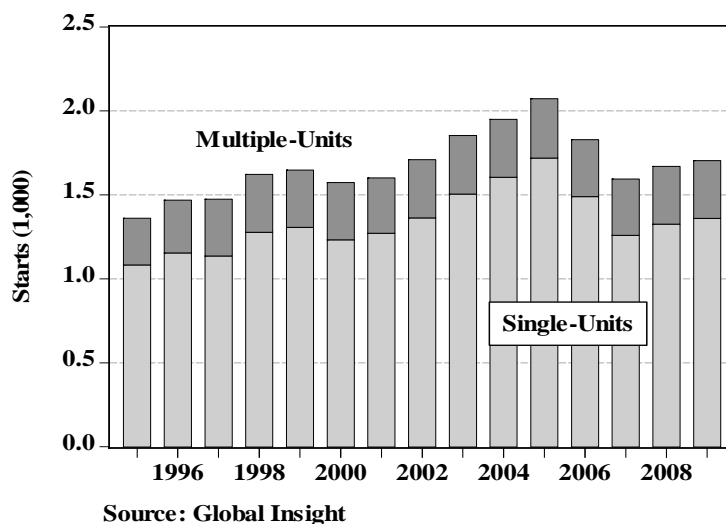


Government: Fiscal year 2006 turned out to be better than expected for federal finances. The federal budget deficit was \$248 billion, down by \$71 billion from \$319 billion the previous year. The deficit was significantly below the White House's January 2006 projection of \$423 billion. The decline in the federal deficit was due primarily to strong economic growth. Nominal GDP grew 6.5% in fiscal year 2006. As a result, individual income taxes jumped 12.6% and corporate income taxes soared 27.2%. Total federal tax receipts increased 11.8%, while outlays rose just 7.4%. Nominal economic growth is expected to slow to about 5% in fiscal year 2007. Therefore, federal government revenue growth should

slow to about 6%. However, government outlays are expected to rise faster. The unchecked spending will put upward pressure on the deficit, causing it to rise to \$287 billion in federal fiscal year 2007 and \$294 billion in federal fiscal year 2008. While mild upward pressure on the deficit is not egregious, the persistent underlying structural deficit could become a burden if the economy slows down faster than had been anticipated.

Housing: The U.S. housing forecast decline is steeper than had been previously believed. The U.S. housing industry continued its slide this summer from its recent dizzying heights. Housing starts fell 6.0% and permits fell 2.3% in August 2006. Existing home sales slipped 0.5% in August, continuing a downward trend that started at the end-of-summer 2005. Year-on-year existing house prices fell in August for the first time since 1995. Faced with these facts and record-high new and used home inventories, it is no wonder builders' confidence was at a 15-year low this summer. As a result of the weaker-than-anticipated housing industry, the forecast for U.S. housing

U.S. Housing Starts



starts have been lowered. National housing starts were reported to fall 7.0% in 2006, 8.9% in 2007, and remain flat at about 1.75 million units thereafter in the July 2006 *Idaho Economic Forecast*. It is now predicted to decline 11.8% in 2006, 12.8% in 2007, increase 4.7% in 2008, and gain another 2.1% in 2009. Despite the late rally, U.S. housing starts will average 1.66 million units, down about 100,000 compared to the previous forecast. The softer housing starts exact a toll on U.S. construction employment, which is expected to have about 150,000 fewer jobs in 2009 than in the previous forecast. Residential construction spending declines at double-digit rates during this year's second half. This decline chops 1.3 percentage points of GDP growth in this year's third and fourth quarters and 0.8 percentage points off GDP in 2007.